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LOGISTICS MANAGEMENT INST WASHINGTON D C  
ADMINISTRATION OF COST ACCOUNTING STANDARDS. (U)  
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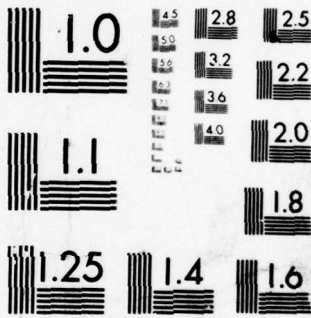
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6 ADMINISTRATION OF  
COST ACCOUNTING STANDARDS.

12 35p.

11 January 1979

10 Richard P. White  
Robert M. Weinstein

9 Final rept.



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210 475  
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## EXECUTIVE SUMMARY

Administration of cost accounting standards (CAS) covers the actions contractors must take to comply with standards, rules, and regulations of the Cost Accounting Standards Board (CASB), as implemented in the Defense Acquisition Regulation (DAR), and also the actions DoD administrative contracting officers (ACOs), aided by Defense Contract Audit Agency (DCAA) auditors, must take to assure contractors' compliance with CAS requirements.

The objective of this study was to identify ways DoD could simplify administration and thereby perhaps reduce the costs to itself and its contractors, of complying with the standards.

We found that CAS administrative requirements were not the major problem. We concluded that simplification of administration by extensive revision of procedures was not necessary.

LMI found the major problem is the difficulty many ACOs experience in executing CAS requirements, i.e. determining the adequacy and compliance of present and proposed cost accounting practices, the impact of changes on contract costs and the significance and materiality of reported noncompliances. As a group, ACOs are inadequately prepared to make the required decisions and rely instead on the advice of DCAA auditors. The average ACO lacks the formal accounting education needed to understand the cost accounting theory and practice embodied in the standards and has not received adequate training and guidance.

The LMI study team also found that administration is more intensive where the DoD contract administration activity is located at the contractor's plant. As a rule, on-site offices are better staffed to carry out CAS administration than are area offices. In addition, most ACOs in area offices are responsible for administering CAS in contracts with two or more contractors.

We learned that prime contractors rarely administer CAS provisions of their covered subcontracts. (By covered, we mean subcontracts which contain both CAS and administration of CAS clauses.) Meaningful administration of covered subcontracts is likely to occur only when the subcontractor also has covered prime contracts and an assigned ACO available.

LMI therefore concluded that DoD could make more effective use of people and time by improving the capabilities of ACOs. We recommend that DoD:

1. Plan and initiate action to make sure those administering CAS have the knowledge and skills to make required decisions.
  - a. Upgrade the cost accounting skills of ACOs.
    - (1) Encourage and make it possible for ACOs without formal cost accounting education to complete basic accounting courses.
    - (2) Make comprehension of cost accounting principles and practices a prerequisite for holding an ACO's warrant.
  - b. As an interim measure and selectively, case-by-case, designate a contract price analyst or other contract specialist with requisite cost accounting knowledge to be a contracting officer's representative (COR) to administer CAS.

Appointment should last until either the ACO completes required accounting education or the contracts are assigned to another ACO with the appropriate background.

2. Reconstitute the DoD CAS Working Group as the DoD CAS Office to give timely and consistent support to CAS Administrators and assure uniform interpretation of CAS. The CAS Office should:
  - a. Be responsible, within DoD, for all CAS Interpretations and Guidance.
  - b. Be staffed with contract specialists who understand cost accounting.
  - c. Conduct regional workshops for ACOs and auditors immediately after promulgation of a new standard or regulation and assess the need for policy and procedural guidance.
  - d. Discuss proposed guidance with industry representatives before issuance.
  - e. Publish a CAS administration manual for use by ACOs and other operating personnel.
  - f. Be subject to a sunset provision requiring, in two to three years, reevaluation and rejustification of its mission.

3. As a corollary measure, disestablish all special CAS positions in component organizations and assign to other duties CAS monitors and all others now devoting all or significant portions of their time to CAS. Authorize ACOs and auditors convenient, unimpeded access to the CAS Office for guidance.

There are other changes that would make CAS administration more manageable, with little loss of impact. We recommend that DoD consider proposing to the CASB the following changes in its rules and regulations:

1. Limit the application of CAS to major contractors with a sufficient volume of defense business to warrant on-site ACOs and auditors.

The on-site offices are better able, considering workload, proximity, and probable future staffing, to do the required administrative job. Achieving effective CAS administration at a relatively few locations is a realistic and attainable goal. In addition, a relatively small number of major contractors hold the covered contracts which account for most of the defense acquisition dollars.

2. Flow down CAS requirements only to subcontractors who already hold covered prime contracts, whether or not the first recommendation is implemented.

Covered subcontracts rarely are administered if the company does not also hold a covered prime contract.

3. Exempt negotiated defense contracts based on adequate price competition.

Contractor cost data are not used to establish reasonableness of prices of those competitive contracts and there is no link between cost accounting practices and negotiated prices.

To summarize, ACOs as a group need a higher level of formal accounting education to do what is required of them in administering CAS, but it is not likely that there will be sufficient human and monetary resources to mount a DoD-wide improvement program. Therefore, we have recommended that DoD concentrate its resources at the OSD level, to give the CAS program consistent and forceful direction. At the field level, where ACOs must make it all work, DoD should consider requesting the CASB to reduce the CAS target area to noncompetitive contracts with contractors having on-site DoD contract administration offices.

## 1. STUDY PLAN

We first reviewed the requirements for CAS administration contained in Parts 331, 332, and 351 of the CASB regulations; Part 3-12 of the Defense Acquisition Regulation (DAR); Paragraph 3-1200 of the Defense Logistics Agency Contract Administration Manual for Contract Administration Services (DLAM 8105.1); and Appendix L of the Defense Contract Audit Manual (DCAM). These requirements are summarized in the following chapter.

The study team then asked the heads of each Defense Contract Administration Services (DCAS) administration activity — management areas (DCASMA) and plant representative offices (DCASPRO) — listed in the DoD Directory of Contract Administration Services Components, the commanders of four Army plant activities, the contract administration chiefs of 19 Air Force plant offices, and the commanding officers of 19 Navy plant offices to have one administrative contracting officer (ACO) in each organization complete a questionnaire on the administration of CAS (DD-DR&E(OT)7825). ACOs at the DCASMA, who typically administer contracts with many different contractors, were asked to report their experience with a single contractor. A total of 122 DoD organizations were contacted, and responses were received from 82 ACOs: 37 from DCASMA, 13 from DCASPRO, four from the Army, 14 from the Air Force, and 14 from the Navy.

Thirty-two defense contractors indicated a willingness to participate in the survey and were sent a list of questions similar to those in the ACO's questionnaire. Seventeen responded, five of whom also had operating segments submit data. The total number of respondents was 32, 17 corporate or group offices and 15 operating segments, all of whom are referred to as contractors in this report.

Analysis of these data revealed a great deal about CAS administration, how closely practices matched CASB and DoD requirements, and what problems ACOs and contractors were encountering. The key findings are summarized in Chapter 3 and recommendations for improving CAS administration are set forth in Chapter 4. Appendix A contains demographic data on ACOs excerpted from a 1977 study of ACOs' perceptions of CAS impact. Appendix B sets forth suggestions for other actions DoD may wish to consider.

## 2. THE CAS PROCESS

Administration of CAS is made up of two essential parts: actions contractors are required to take, as specified in the CASB rules and regulations and implemented by DoD; and actions DoD ACOs and auditors must take to respond to contractors' initiatives and to ensure their compliance. None of the parties can act independently; every action by one creates a need for reaction by another until they agree that all necessary action has been taken. Effective administration of CAS thus depends on three factors: the efficacy of established requirements and procedures, the abilities of the people involved, and their willingness to make the process work.

Requirements for administering CAS are covered in Parts 331, 332 and 351 of CASB rules and regulations, Part 3-12 of the DAR, Paragraph 3-1200 of DLAM 8105.1 and Appendix L of DCAM.

### STANDARDS AND THEIR APPLICABILITY

Negotiated defense contracts over \$100,000, except for those meeting the exceptions stated in CASB rules and regulations, are made subject to all cost accounting standards by inclusion of the CAS clause and by award of a single covered contract or subcontract in excess of \$500,000. P.L. 87-653 covering submission of certified cost or pricing data, and P.L. 91-379, the act creating the CASB, have very similar applications. However, while P.L. 87-653 exempts contracts where negotiated prices are based on adequate price competition, P.L. 91-379 does not.

Standards in effect when this study began were:

#### Effective 1972

- 401 Consistency in estimating, accumulating and reporting costs; promulgated 29 February 1972.
- 402 Consistency in allocating costs incurred for the same purpose; promulgated 29 February 1972.

Effective 1973

- 403 Allocation of home office expenses to segments; promulgated 14 December 1972.
- 404 Capitalization of tangible assets; promulgated 27 February 1973.

Effective 1974

- 405 Accounting for unallowable costs; promulgated 6 September 1973.
- 406 Cost accounting period; promulgated 7 November 1973.
- 407 Use of standard costs for direct material and direct labor; promulgated 1 April 1974.

Effective 1975

- 408 Accounting for costs of compensated personal absence; promulgated 19 September 1974.
- 409 Depreciation of tangible capital assets; promulgated 29 January 1975.

Effective 1976

- 410 Allocation of business unit general and administrative expenses to final cost objectives; promulgated 16 April 1976.
- 411 Accounting for acquisition cost of material; promulgated 5 May 1975.
- 412 Composition and measurement of pension cost; promulgated 24 September 1975.
- 414 Cost of money as an element of the cost of facilities capital; promulgated 2 June 1976.

Effective 1977

- 415 Accounting for the cost of deferred compensation; promulgated 30 July 1976.

Effective 1978

- 413 Adjustment and allocation of pension cost; promulgated 20 July 1977.

CASB rules and regulations provide that a business unit need only comply with standards 401 and 402, if it is not awarded a single covered contract of \$10 million or more, or if covered contracts awarded in its immediately preceding cost accounting

period total less than \$10 million, if the sum of those awards equals less than 10 percent of the business unit's total sales during that period. However, if the business unit is part of a company required to submit a disclosure statement, it also must disclose its cost accounting practices.

#### DISCLOSURE STATEMENTS

All solicitations likely to result in negotiated contracts in excess of \$100,000, with certain exceptions stated in DAR, are to contain a notice explaining that the resulting contract may be subject to the requirements of the CASB. The notice also states that the qualifying contractor, as a condition of contracting, must submit a disclosure statement.

CASB regulations require a company to submit a completed disclosure statement if it receives a negotiated national defense contract award subject to CAS and for \$10 million or more, or if it, together with its subsidiaries, received net awards of covered prime contracts and subcontracts totaling more than \$10 million in its most recent cost accounting period.

DAR contains requirements for initial review of contractors' disclosure statements and changes in cost accounting practices. The auditor reviews the disclosure for adequacy and informs the ACO, who in turn determines adequacy or inadequacy and notifies the contractor. Normal time for this determination is 30 days. Subsequent to the notification, the auditor reviews the disclosure for compliance with CAS and DAR Section XV and advises the ACO of any findings.

Neither DAR nor DCAM specifies a time limit for determining compliance but DLAM 8105.1 states that the auditor's review generally should be completed within 60 days of the adequacy notification and that, in most cases, the ACO will be advised of audit findings only if a noncompliance is found. DCAM states that a report on overall compliance will not be issued.

By the time of our study, six years after the CASB implemented the disclosure requirements, submission and review of initial disclosure statements has been completed.

Most of the effort now is expended keeping the statements current with new standards and changed practices or, if necessary, on revising them completely.

#### CHANGES IN ACCOUNTING PRACTICES

If the contractor has a covered contract or subcontract, cost accounting practices must be changed if necessary to conform to newly promulgated standards. These are called mandatory changes. Practices also may be changed voluntarily by agreement of both parties. If the contractor has submitted a disclosure statement, any change in a disclosed practice, for whatever reason, requires that the statement be amended.

The CAS clause requires the contractor to follow disclosed practices consistently in accumulating and reporting contract performance cost data. If a disclosed practice is changed on any covered contract or subcontract, the change must be applied prospectively to all other covered contracts and subcontracts and the disclosure statement must be modified. The contractor also shall agree to an equitable adjustment if contract cost is affected by a mandatory change to established cost accounting practices, whether or not such practices are covered by a disclosure statement.

As disclosed practices are changed, only those pages of the disclosure statement containing the revision are to be resubmitted. Normally, the ACO should require resubmission of a complete, updated disclosure statement only when the review process would be expedited substantially as a result of the resubmission.

The CAS clause also provides for equitable adjustment to affected contracts for voluntary changes agreed to by both parties, if the contracting officer finds the change desirable and not detrimental to the interests of the Government. Otherwise, agreement to a voluntary change may not be made if it would increase the costs paid by the United States. In addition, the contractor shall agree to an adjustment of contract price or cost allowance for failure to comply with an applicable standard or to follow any disclosed practice, if the failure results in any increased costs paid by the United States. The adjustment shall provide for recovery of increased costs plus interest.

The administration of CAS clause requires the contractor to submit to the ACO a description of the accounting change and an estimate of its general dollar magnitude, including the increases and decreases for all covered contracts. Mandatory changes are to be submitted within 60 days (or other agreed-to date) after award of a contract requiring such change. Proposed voluntary changes are to be submitted not less than 60 days (or other agreed-to date) prior to the effective date of the proposed change. Changes to correct noncompliances are to be submitted within 60 days (or other agreed-to date) of the date the contractor agrees that there is a noncompliance.

After receipt of a change proposal, the auditor reviews the change for both adequacy and compliance concurrently and reports the results to the ACO. The ACO determines adequacy and compliance and notifies the contractor. The contractor is required to submit a cost impact proposal in the form and manner specified by the ACO, within 60 days (or other agreed-to date) of the date when the ACO determines the change to be adequate and compliant and to agree to appropriate contract and subcontract amendments.

The CASB has stated that how a contract is modified to give effect to a cost impact is a contract administration matter. The adjustment may be made to a single contract, several contracts, or by other means. The CASB does not restrict how this is done.

#### MATERIALITY

The CASB provides that contracts need to be modified only if the cost impact is material. It provides six criteria for determining whether costs are material or immaterial and states that no one criterion is necessarily determinative. The criteria are:

1. Absolute dollar amount.
2. Amount of contract cost compared with the amount under consideration.
3. Relationship between a cost item and a cost objective.
4. Impact on Government funding.

5. Cumulative impact of individually immaterial items.
6. Administrative cost of processing the price adjustment.

DLAM 8105.1 repeats the first five criteria, but substitutes relationship to price for the CASB criterion of administrative cost.

### SUBCONTRACTS

Defense subcontractors are to use CAS in estimating, accumulating, and reporting costs in connection with pricing, administering, and settling negotiated defense subcontracts in excess of \$100,000. The CASB defines a "defense subcontractor" as:

...any person other than the United States who contracts, at any tier, to perform any part of a defense contractor's contract... A 'negotiated subcontract' is any subcontract except a firm fixed-price subcontract made by a contractor or subcontractor after receiving offers from at least two firms not associated with each other or such contractor or subcontractor, providing (1) the solicitation to all competing firms is identical, (2) price is the only consideration in selecting the subcontractor from among the competing firms solicited, and (3) the lowest offer received in compliance with the solicitation from among those solicited is accepted.<sup>1</sup>

Contractors with contracts containing the CAS clause are to include the substance of that clause in negotiated subcontracts in excess of \$100,000 with certain stated exceptions. Subcontractors are to submit disclosure statements to the contractor but may, when such is the case, certify to the contractor that the statements have been submitted to a Government ACO. Subcontractors have the right to refuse to submit disclosure statements to the contractor or higher tier subcontractor. In such cases, subcontractors are to submit disclosure statements directly to the contractor's ACO.

DoD policy assigns to the prime contractor or higher tier subcontractor the responsibility for administering CAS requirements contained in subcontracts they award. However, subcontractor CAS reviews usually are performed by the Government.

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<sup>1</sup> This definition of a negotiated subcontract in effect excludes only the commercial equivalent of the formally advertised contract, one where price is the only consideration and award is made to the lowest bidder. This situation rarely exists. LMI in its November 1978 report Subcontracting Policy in Major Systems Acquisitions, (RE802), noted that no subcontracts, in the four programs studied, were awarded solely on the basis of price.

## NONCOMPLIANCE

The CAS clause requires the contractor to follow disclosed practices consistently in accumulating and reporting performance cost data under the covered contract. The contractor also is to comply with all standards in effect at the time of award and comply prospectively with new standards that become applicable to any of its contracts or subcontracts. If the contractor or a subcontractor fails to comply with an applicable standard or to follow any disclosed practice and this failure results in any increased costs paid by the United States, the contractor is to agree to an adjustment of contract price or cost allowance to provide for recovery of costs, plus interest.

Where the contractor inadvertently fails to use applicable standards or to follow disclosed practices and the result of such failure is to increase costs paid, the CASB urges the contracting officer to require repayment of the excess of increased over decreased costs, together with any applicable interest.

DoD implementation of CASB regulations pertaining to noncompliance provides that:

1. The ACO shall make an initial finding of compliance or noncompliance within 15 days of receiving a noncompliance report from the auditor.
2. If an initial finding of noncompliance is made, the ACO shall give the contractor 30 days to agree or submit reasons for disagreement.
3. If the contractor agrees, it shall correct the noncompliance and submit a description of the change and its general dollar magnitude (the net of increases and decreases of all covered contracts).
4. The ACO shall review the proposal for adequacy and compliance concurrently and ask the contractor to submit a cost impact proposal.
5. Upon receipt of the proposal, the ACO shall analyze and negotiate the contract price adjustments.

If a noncompliant contractor does not change a cost accounting practice because the cost impact is immaterial, the ACO is to advise the contractor that if the noncompliance subsequently results in increased costs to the Government, the provisions of the CAS clause will be enforced.

## DoD CAS MANAGEMENT

The DoD created the CAS Steering Committee to provide top management surveillance over all matters related to CAS and to:

1. Establish policy guidelines for administration of CAS.
2. Promulgate interim guidance as appropriate for timely and efficient administration of CAS.
3. Maintain liaison with the Office of Federal Procurement Policy and the CASB on major issues.
4. Respond to congressional inquiries.

DoD also created the CAS Working Group to operate under the general guidance and direction of the CAS Steering Committee to accomplish these tasks. The working group has issued 22 guidance papers, the first 18 of which were designated "interim". For the most part, the papers have been written in response to questions asked of the working group or referred to it by DoD components. The 22 are numbered sequentially following the letters "W.G." and the last two digits of the calendar year of issue. W.G. 76-1 through W.G. 77-17 were republished in Defense Procurement Circular #76-11, 30 September 1977.

### 3. SUMMARY OF FINDINGS

This chapter summarizes the findings and describes the interaction of contractor and Government people administering CAS.

#### THE ACO

The basic requirements and procedures for CAS administration are dictated by CASB rules, regulations, and standards. The contractor is required to: (1) disclose cost accounting practices followed in accumulating and reporting costs, if sales under covered negotiated defense contracts (contracts subject to cost accounting standards) meet or exceed thresholds established by the CASB; (2) follow disclosed or established cost accounting practices consistently in estimating, accumulating, and reporting costs under individual covered contracts; (3) review disclosed or established cost accounting and estimating practices upon promulgation of a new standard and, if necessary, revise the practices, with the agreement of the ACO; (4) make other changes in cost accounting and estimating practices, with the ACO's concurrence, as dictated by changed circumstances or the contractor's failure to follow disclosed or established practices or to comply with the standards; (5) adjust prices or cost allowances of covered contracts, after negotiation with the ACO, if changes to practices or noncompliances have had a material impact on contract costs; and (6) include the substance of the CAS contract clause in subcontracts under covered contracts.

The ACO must see that the contractor follows the CAS provisions of both solicitation and contract documents. The DCAA auditor is responsible for reviewing and advising the ACO on the contractor's disclosures, proposed changes, estimates of cost impact, and the contractor's noncompliance with disclosed or established practices and CAS requirements discovered in the course of normal audit activities.

The concept of a contracting officer that underlies many DAR policies and procedures is that of a specialist in the functional, legal, and procedural requirements of contracting and a generalist in most of the other disciplines involved in the acquisition process. Under this prevailing concept a contracting officer is a manager, a problem solver, a person who accepts responsibility and gets things done by marshalling the resources of the organization and making decisions so that the contract work is completed on time, the deliverables meet the contract requirements, and the cost to the Government is fair and reasonable.

Only a relatively few ACOs have the time or the background to perform CAS administration adequately. The ACO is authorized to perform 69 contract administration functions, including four involving CAS. Although specialists in contract administration are assigned to detailed, day-to-day work in many of the functional areas, the ACO is responsible for assuring that the contractor's performance in those areas conforms with contract terms.

Some ACOs are more active than others in CAS matters. This depends on the amount of time available, the activity of the DCAA auditor, how closely the contractor's cost accounting practices conform to CAS requirements, how stable the contractor's business and organization is, and how consistently the contractor follows disclosed or established cost accounting practices. An ACO located on-site at a contractor's plant is more active in CAS administration than an ACO assigned to a DCASMA.

For example, 83 percent of the contractors administered by DCASMA ACOs made three or fewer accounting changes to comply with newly promulgated standards. These 36 contractors made a total of 81 mandatory changes, an average of 2.2 per contractor. By comparison, 60 percent of the contractors administered by resident ACOs made three or fewer mandatory changes. The 45 contractors in this category made a total of 155 changes, an average of 3.4 per contractor.

The same is true for voluntary changes. Two-thirds of the contractors administered by DCASMA ACOs proposed three or fewer accounting changes. The total number of voluntary changes was 164, an average of 4.6 per contractor. By contrast, fewer than half of the contractors with resident ACOs proposed three or fewer changes. Their proposed changes totaled 413, an average of 9.6 per contractor.

Noncompliances permit a similar comparison. Fifty-six percent of the contractors administered by DCASMA ACOs received three or fewer noncompliance notices. Non-compliances totaled 178 for an average of 4.9 per contractor. Only 34 percent of the contractors with resident ACOs received three or fewer noncompliance notices. The total number was 423, an average of 9.6 per contractor.

The complexity of cost accounting principles and concepts and the specific requirements of standards, demands a level of accounting expertness relatively few ACOs possess. Based on 1977 data summarized in Appendix A, a significant majority of ACOs have a bachelor's degree or less; 43 percent have no degree, and 28 percent have bachelor's degrees. Forty-two percent of the ACOs have had six or fewer credit hours of formal accounting education, and 24 percent have had between seven and 12 credit hours. Most ACOs (54 percent) administer covered contracts of two or more contractors; 24 percent administer covered contracts of five or more contractors.

Thus, many ACOs need formal accounting education as well as CAS training. The DoD CAS Working Group noted its 1977 field survey:

Ideally, all contracting officers should be capable of understanding CAS problems and making their own decisions based on that knowledge... Informal discussions with personnel who teach the CAS Workshop at ALMC indicate that a number of ACOs attending that course have been unable to understand the complex accounting which is inherent in CAS. Under these circumstances it cannot be expected that many ACOs will be able to deal with CAS unless they are first taught the fundamentals of accounting... In recent CAS workshops ALMC has had trouble filling the available spaces...discussions with field people indicated they were unable to get spaces for people they wished to send... (There are) problems of travel and per diem cost and time off the job. (p. 23)

Initial CAS training for ACOs has been skimpy and has not been reinforced. Training funds are relatively scarce and spaces in the ALMC course are not readily

available. One ACO suggested seminars for operating personnel as soon as possible after promulgation to discuss each new standard.

In addition to formal accounting education and initial training in CAS administration, more adequate and timely interpretations and guidance are needed. Our data show that ACOs need interpretations of the requirements of individual standards and guidance as to cost impact statements, materiality, and equitable adjustment of contracts, particularly for firm fixed-price contracts and situations where a proposed change affects the prices or cost allowances of many different types contracts.

The ACO has essentially a reactive role. The CAS administrative process is set up so that either the contractor or the auditor takes an action—proposes a cost accounting change, submits a cost impact statement, issues a noncompliance notice, advises as to adequacy or inadequacy, compliance or noncompliance—that requires the ACO to make a decision on an accounting question. Several contractors said that the ACO usually accepts the auditor's position on an issue and is extremely reluctant to move from it in discussions with the contractor.

While no ACO said the same thing in so many words, support for this assertion is found in the number of ACOs who said the standards were not clear, too complex and lacking in clear direction. Others said that standards provided too many options, too broad a range for interpretation. While we could argue that at least some of the standards would benefit from editing and rewriting, we believe they can be administered adequately by an ACO who is comfortable with accounting problems. We believe an expressed desire for standards that do not require or permit interpretation in light of particular circumstances is an indication of unwillingness or inability to accept responsibility for resolving accounting problems.

#### CHANGES

Most CAS administration effort and ACO decisions are caused by the need to make changes to disclosure statements and covered contracts to comply with new standards, adjust for voluntary changes, or correct noncompliances.

For initial disclosure statements, the first decision point is the ACO's determination of adequacy. After that, compliance becomes the issue. The auditor does not immediately undertake a special compliance review, but advises the ACO when, in the course of subsequent audit activity, there is reason to question compliance. Thus, for initial disclosure statements, compliance is handled on an exception basis and nothing may happen for months after the ACO determines that the disclosure is adequate.

However, emphasis now has shifted from initial to completely revised disclosure statements. The DAR does not say if this same procedure is to be followed when the ACO requires the contractor to resubmit a complete, updated disclosure statement, or whether the proposed change is to be reviewed for adequacy and compliance simultaneously.

There have been disagreements among contractors, ACOs, and auditors as to the amount of detail in which proposed new practices are to be described and the criterion for requiring resubmission of a complete, as opposed to a single page, revision. Some auditors and ACOs require what contractors maintain is excessive detail in support of proposed changes. Some ACOs require complete revision of a disclosure statement after five changes, others require revision after six; the DAR only requires complete revision when it would expedite the review process substantially.

Determining the need for and extent of changes in the prices and cost allowances of existing covered contracts is a major task. Contract adjustment is complicated by the fact that covered Government contracts usually coexist in a contractor's plant with Government contracts and commercial work that are not subject to CAS requirements. This is so because the act creating the CASB made the contract the instrument for implementing CAS and limited application to negotiated national defense contracts. Coexistence of covered and noncovered work in a single business unit has caused contractors to follow at least two sets of cost accounting practices. Even where the same practices apply to all work in the business unit, only covered contracts can be adjusted to mitigate the effect of a change.

Change administration is complicated further because negotiated defense contracts awarded on the basis of adequate price competition are not exempt from CAS application. Cost or pricing data, including cost accounting data, are not to be used to negotiate the prices of those contracts. Accordingly, where cost data are not used, there is no link between cost accounting practices and negotiated price and no baseline against which to measure the impact of a changed accounting practice.

Upon promulgation of a standard, the contractor must review disclosed or established practices to determine compliance. If practices must be changed, the contractor gives the ACO a description of the accounting change and its general dollar magnitude, made up of all decreases and increases to all covered contracts. The ACO reviews the proposed change for adequacy and compliance. When satisfied that the change does comply, the ACO requests the contractor to submit a cost impact proposal in sufficient detail to permit evaluation and negotiation of the cost impact upon each covered contract and subcontract. The proposal is to include the effect on each contract and subcontract from the date the contractor is required to follow the standard until completion of the contract or subcontract.

Fourteen of the 15 standards issued when the data gathering phase of this study began in May 1978 could have made it necessary for a contractor to change cost accounting practices. The 82 ACOs who participated in the study reported that their contractors had made a total of 217 mandatory changes and that fewer than 20 percent of the changes had had a material impact on contract costs. Two-thirds of the 217 changes were caused by five standards, CAS 409, 410, 404, 403 and 401.

Most problems in administering mandatory changes are related either to cost impact determinations or to differing interpretations of the standards. We found no evidence that procedures need to be modified. We did learn that some ACOs, as a regular practice, meet with the auditor and the contractor soon after a new standard is released to discuss and agree on an interpretation of its requirements before the contractor undertakes a

review of current practices. This procedure could benefit both parties and help shorten the implementation time, which both ACOs and contractors said was too long.

The auditor advises the ACO of all instances of suspected noncompliance, without regard for the materiality of the impact on contract costs. The ACO must decide if the auditor's position is well-founded and, if it is, notify the contractor. The contractor, in turn, must agree or show that the questioned practices are in compliance.

Relatively few noncompliance notices have had a material impact on costs. Of 503 noncompliance issues reported by ACOs as settled, 11 percent resulted in contract adjustments, even though 45 percent led to changed practices. Contractors reported 109 noncompliance issues settled, of which 7 percent resulted in contract adjustments and 43 percent in changed practices.

If we assume that about half of all noncompliance notices will result in changed practices, an assumption supported by these data, there is reason to believe that at least some of the other 50 percent should have been stopped by the ACO before going to the contractor. Because just over 10 percent of the total, or 20 percent of the noncompliances that resulted in changes, had cost impact significant enough to require contract adjustment, it is likely that the ACO, without undue risk, could have cut the process short on a significant number of noncompliances.

However, we could not discover if the reported noncompliances include inconsistencies between estimating and accounting practices that are spotted in proposal analysis and corrected by the contractor in a revised proposal or by the PCO in the subsequent negotiation of contract price. The potential for saving time and effort would be diminished by however many of these noncompliances are included in the data.

#### COST IMPACT PROPOSALS

The administration of CAS clause requires the contractor to submit a cost impact proposal within a specified number of days after the date the ACO determines that a proposed change is adequate and compliant. This requirement causes problems. Some

contractors delay submission of the cost impact proposal or claim that there is no impact on the cost of covered contracts. This forces the auditor and ACO to develop their own estimate if they do not accept the contractor's position. Some ACOs and auditors require too much detail. Both ACOs and contractors have difficulty developing a cost impact statement and estimating the present and future impact on each outstanding covered contract and subcontract. There continue to be questions about whether to use the original cost estimate or the current estimated cost to complete in determining cost impact. One contractor suggested that the estimate of general dollar magnitude submitted with the proposed change often is a reliable statement of impact and that regulations should make it clear that the ACO can make a final decision on that basis. Many do that now, but it could be done more frequently. We also found that some ACOs were requiring cost impact statements for the record after agreeing the change would have no material effect on contract costs. Official sanction of the use of the more general initial estimate might make this sort of insurance less important.

#### SUBCONTRACTS AND SUBCONTRACTING

Energetic administration of CAS requirements in subcontracts would require the prime contractor to have access to the subcontractor's financial data, which are not customarily made available to the industrial buyer. For this reason, few contractors do little more than include the proper provisions in solicitations, obtain the necessary certifications, and insert the substance of the CAS and administration of CAS clauses in appropriate subcontracts. An earlier LMI report noted:

The usual practice is for a prime contractor to rely on DoD's administrative and audit apparatus to follow through on CASB requirements... There is little indication that anything is done if the subcontractor has no CAS-covered prime contracts.<sup>1</sup>

The DoD CAS Working Group's 1977 field survey report said much the same thing.

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<sup>1</sup>Cost Impact of Cost Accounting Standards (Washington, D.C.: Logistics Management Institute) November 1977, page 10.

We asked contractors if they had covered subcontracts, and if they did, if the prime contractors administered the CAS provisions. Only two of 25 contractors said the prime contractor was involved. While 30 of 68 ACOs said the prime contractor was involved in subcontract administration, further questions established that involvement usually ended with the award of the subcontract.

The prime contractor must include a provision in covered subcontracts requiring the subcontractor to notify the cognizant contract administration office that it has the subcontract and to furnish certain data to the ACO. (If the subcontractor has no prime defense contracts, there probably will be no cognizant contract administration office.) This provision is difficult to enforce and frequently is overlooked. Of 67 ACOs, only 28 said they were informed routinely of the presence of a covered subcontract; 39 were not. Of 24 contractors responding to a similar question, 13 said they routinely informed the ACO, and 11 said they did not.

#### 4. CONCLUSIONS AND RECOMMENDATIONS

Our study findings confirm the existence of administrative problems in two broad categories: problems that originate in specific requirements of P.L. 91-379, as implemented in the rules and regulations of the CASB; and problems related to the nature of the administrative tasks and the environment in which the tasks must be performed.

The requirements of the act creating the CASB impose outside restraints on cost accounting practices that company managers traditionally have considered to be totally theirs to devise and revise. Some companies approach CAS negatively, with an attitude of "you can't tell me how to run my business." We found strong indications of delaying tactics and a reluctance to do anything until pressured. Some Government personnel have used CAS as a weapon to force the contractor to accept Government-proposed changes. This adversary relationship is to a certain extent an inevitable outgrowth of the conflicting business objectives of the contractor as seller and the Government as buyer. The uncertainties surrounding the introduction and administration of a new process compound these difficulties. The standards still are fairly new and a body of interpretations and precedents has been slow to develop. Some contractor and Government personnel are relatively inexpert at administering CAS and have been involved in the process sporadically. Where the volume of covered contracts is great enough, time and training should reduce these problems.

The problems related to the nature of the administrative tasks are really the hard decisions that those with authority are required to make. Someone must decide for the Government that a disclosure statement adequately describes the contractor's cost accounting practices and that those practices comply with CAS. Someone must decide that a proposed cost accounting change is adequate and compliant, determine its impact on existing contracts, decide if the impact is material and, if it is, negotiate an adjustment to affected contracts. Someone must decide if the contractor has failed to

follow disclosed or established practices or is otherwise noncompliant, decide if the cost impact is material and if so, negotiate contract adjustments and interest thereon.

DAR now authorizes the ACO to make those decisions. Although our findings cast doubt on the average ACO's discharge of these responsibilities, we believe that appropriate actions by DoD and the CASB can solve the problems. However, DoD's actions do not depend on concurrent or complementary action by the board. One other factor is central to our evaluation of CAS administration: DoD contract administration organizations do not now have, and are not likely to acquire, the number of fully qualified personnel needed to administer CAS on the present and probable future scale dictated by the number and complexity of CASB issuances.

#### RECOMMENDATIONS FOR DoD ACTION

1. Plan and initiate action to make sure those administering CAS have the knowledge and skills to make required decisions.

This is a formidable task that cannot be completed in short order. There are limits imposed by personnel ceilings and the availability of training spaces and travel funds. The payback from this training will be better administration and the accomplishment of necessary tasks in less time; there may be no direct payback in reduced contract prices or cost allowances. The point of this recommendation is to establish a plan and begin its implementation.

- a. Upgrade the cost accounting skills of ACOs.
  - (1) Encourage and make it possible for ACOs without formal cost accounting education to complete, within a reasonable time, the cost accounting courses needed to understand and evaluate cost accounting principles and practices. A concerted attempt should be made to make sure all ACOs with a sound grasp of cost accounting have the opportunity to attend the ALMC CAS training course.
  - (2) Make comprehension of cost accounting principles and practices a prerequisite for holding an ACO's warrant.
- b. As an interim measure and selectively, case-by-case, designate a contract price analyst or other contract specialist with requisite cost accounting knowledge to be a contracting officer's representative (COR) to administer CAS.

This individual should receive and evaluate all input from contractors and DCAA auditors, recommend appropriate actions to the ACO or ACOs, and prepare all documents required to implement the decisions recommended. This individual should be able to handle CAS for the contract administration office. Appointment as a COR should last until

either the ACO acquires necessary accounting education or the contracts are assigned to another ACO with the appropriate background.

2. Reconstitute the DoD CAS Working Group as the DoD CAS Office to give timely and consistent support to ACOs, ACO representatives, and DCAA auditors, and assure uniform interpretation of CAS. The CAS Office should:

- a. Be responsible, within DoD, for all CAS interpretations and guidance.
- b. Be staffed with contract specialists who understand cost accounting.

While it might be productive if all major DoD components were represented in the CAS Office, that should not be a primary criterion. If existing CAS monitor assignments are terminated (see 3 below), some of those specialists might be reassigned to the CAS Office.

- c. Conduct regional workshops for ACOs and auditors immediately after promulgation of a new standard or regulation and assess the need for policy and procedural guidance.

Any written material should be issued before either the effective date of the standard or regulation or the date the standard is to be applied to a contractor's accounting system. If the subject warrants, the material should be recommended for publication in DAR.

- d. Discuss proposed guidance with industry representatives before issuance.

Effective administration requires the cooperation of the contractors whose cost accounting practices must comply with CAS.

- e. Consider publishing a CAS administration manual for use by ACOs and other operating personnel.

- f. Be subject to a sunset provision requiring, in two to three years, reevaluation and rejustification of its mission.

Within two years, or three at the most, the majority of ACOs should have acquired required education and training and administration of CAS should be an integral part of an ACO's assignment. When that point is reached, the CAS Office can be eliminated and CAS questions can be handled in the same fashion as questions of cost allowability.

3. As a corollary measure, disestablish all special CAS positions in component organizations and assign, to other duties, CAS monitors and all others now devoting all or significant portions of their time to CAS. Authorize ACOs and auditors convenient, unimpeded access to the CAS Office for guidance. This streamlining would shorten communication lines and reduce the incidence of conflicting interpretations. We believe CAS requires special attention for the next two to three years and this special organizational approach will provide this in the simplest and most direct way.

4. The findings and conclusions which led us to recommend special efforts to increase the average ACO's ability to handle the issues raised by CAS might have led to a recommendation that authority for CAS administration be assigned to the DCAA auditor. We did not consider this to be a viable

alternative because we believe administration of CASB rules, regulations and standards, made applicable to defense contractors by means of contract clauses, is a contracting function. DoD had concluded this in 1972 and assigned the function to ACOs. We believe this conclusion still is valid. Actions taken and decisions reached pursuant to contractual requirements are and should remain with the contracting officer in order to maintain responsibility, accountability and control.

#### RECOMMENDATIONS REGARDING CASB RULES AND REGULATIONS

Three changes in CASB rules and regulations would reduce the dimensions of the total administration problem with little reduction in the total impact of CAS. We recommend that DoD consider proposing the following changes to the CASB:

1. Limit the application of CAS to major contractors with sufficient volume of defense business to warrant on-site ACOs and auditors.

Other contractors currently covered would still be subject to other DoD requirements relating to cost and price or, if so desired, could be subject also to CAS 401 and CAS 402 and the provisions in the contract clause in Sec. 332.50 relating to compliance with established practices and adjustment of contract for failure to comply. Disclosure should not be required.

Realistically, the class of contractors that would be excluded if this change were made, now are subject to little more than pro forma CAS administration. However, even assuming DoD had the resources to divert to CAS, the cost of doing so would be disproportionate to the probable return. As an alternative, it would be better for DoD to concentrate its limited resources on the relatively few contractors who account for the major share of the DoD acquisition budget.

2. Flow down CAS requirements only to subcontractors who already hold covered prime contracts, whether or not the first recommendation is implemented.

Adoption of this change would require amendment of P.L. 91-379, unless the CASB's authorization to make, promulgate, amend, and rescind rules and regulations provided in (h)(1) of that act extends to such a change. This recommendation is based on our finding that CAS provisions of subcontracts are subject to meaningful administration only if the Government administrative apparatus already has been activated by the award of covered prime contracts.

3. Exempt negotiated defense contracts based on adequate price competition.

We believe it is unnecessary and nonproductive to apply CAS to competitive contracts negotiated and awarded on the basis of price analysis, where contractual cost data are not used to establish the reasonableness of offered prices. If cost accounting data are not the basis for determining a contract price, there is no rationale or factual basis for adjusting that price later if cost accounting practices change.

In summary, ACOs as a group need a higher level of formal accounting education to do what is required of them in administering CAS, but it is not likely that there will be sufficient human and monetary resources to mount a DoD-wide improvement program. Therefore, we have recommended DoD concentrate its resources at the OSD level to give the CAS program consistent and forceful direction. At the field level, where ACOs must make it work, DoD should consider requesting the CASB to reduce the CAS target area to noncompetitive contracts having on-site DoD contract administration offices.

APPENDIX A  
DEMOGRAPHIC DATA — DOD ACOs

A master's thesis by a student at the Air Force Institute of Technology<sup>1</sup> provides some demographic data on DoD ACOs in mid-1977. The following tables present a composite picture of ACO experience, involvement in CAS administration, grade, education and formal accounting education when that study was undertaken.

TABLE 1  
LENGTH OF TIME IN GOVERNMENT  
CONTRACT ADMINISTRATION (321 ACOs)

<u>YEARS</u>	<u>NUMBER</u>	<u>PERCENT</u>
1 to less than 5	11	3.4%
5 to less than 10	28	8.7
10 to less than 15	81	25.2
15 to less than 20	66	20.6
20 to less than 25	94	29.3
25 or more	<u>41</u>	<u>12.8</u>
TOTAL	321	100.0%

TABLE 2  
NUMBER OF CONTRACTORS SUBJECT TO COST ACCOUNTING  
STANDARDS ADMINISTERED BY ONE ACO (319 ACOs)

<u>NUMBER OF CONTRACTORS</u>	<u>NUMBER OF ACOs</u>	<u>PERCENT</u>
1	146	45.8%
2	34	10.7
3	32	10.0
4	18	5.6
5	14	4.4
5 or more	<u>75</u>	<u>23.5</u>
TOTAL	319	100.0%

<sup>1</sup>"ACO Perceptions Regarding the Uniformity and Consistency in Defense Contractor Cost Accounting Practices Achieved by Cost Accounting Standards 401-408", Joe M. Banks, Capt USAF, December 1977.

TABLE 3  
GRADES OF 321 ACOs

<u>GRADE</u>	<u>NUMBER</u>	<u>PERCENT</u>
GS-12	215	67.0%
GS-13	70	21.8
GS-14	31	9.7
0-3	4	1.2
0-5	<u>1</u>	<u>.3</u>
TOTAL	321	100.0%

TABLE 4  
HIGHEST LEVEL OF FORMAL EDUCATION (321 ACOs)

<u>EDUCATION LEVEL</u>	<u>NUMBER</u>	<u>PERCENT</u>
Less than bachelor's degree	139	43.3%
Bachelor's degree	89	27.7
Graduate work beyond bachelor's degree	55	17.1
Master's degree & beyond	32	10.0
Doctorate degree	<u>6</u>	<u>1.9</u>
TOTAL	321	100.0%

TABLE 5  
APPROXIMATE HOURS/CREDITS OF FORMAL ACCOUNTING  
EDUCATION (320 ACOs)

<u>HOURS/CREDITS</u>	<u>NUMBER</u>	<u>PERCENT</u>
6 or less	134	41.9%
7-12	77	24.1
13-18	36	11.2
19-24	19	5.9
25 or more	<u>54</u>	<u>16.9</u>
TOTAL	320	100.0%

## APPENDIX B SUGGESTIONS FOR OTHER ACTIONS

Study of CAS administration led to conclusions that extensive revision of procedures was not necessary but that ACOs were being asked to make difficult decisions that many were ill-prepared to make. If administration were to be simplified, we concluded that DoD should concentrate on improving the lot of the ACO by formal education, training, and increased management support and guidance, and petition the CASB to limit application of CAS to noncompetitive contracts with major defense contractors with on-site ACOs and auditors.

Some findings were not included in the report. Nevertheless, they are valid concerns and we suggest them for DoD's consideration in its continuing efforts to simplify the administrative process.

1. Is a complete revision to a disclosure statement to be processed in the same way as an initial disclosure? Does the ACO determine adequacy and then handle compliance on an exception basis or are adequacy and compliance determined simultaneously? We believe a complete revision is just a big change, and that it is sounder to agree on the changed practices as soon as possible. Therefore, we suggest this be made the procedure to follow.

2. Both contractors and ACOs said the 60-day advance notice of a proposed voluntary change was not realistic, although the bases for their statements were not necessarily the same. There were statements that a 60-day period was too short, too long, or inoperative. What is to happen if a contractor proposes a change to take effect within 45 days? What is intended if the contractor proposes a change to take effect retroactively to the start of its fiscal year? We don't have the answers, beyond acknowledging that the administration of CAS clause permits the parties to agree to some other number of days. We suggest that DoD establish the significance of the uncertainties in this provision and take action appropriate to that conclusion.

3. The auditor is to advise the ACO of all suspected noncompliances without regard for significance or materiality. Is this a reasonable requirement if, as the study found, less than half of all noncompliance notices lead to changed accounting practices and only a small portion of these are judged to have a material effect on contract costs? This requirement creates a paper mill. Shouldn't the auditor be permitted some discretion, be allowed as an accountant, to weigh significance of a particular practice? Wouldn't it be simpler and just as effective if the standard procedure were for the auditor to discuss findings and concerns with the ACO before reaching a decision and writing a report? We believe the answer to both questions should be yes. Therefore, we suggest appropriate procedures be adopted.

UNCLASSIFIED

SECURITY CLASSIFICATION OF THIS PAGE (When Data Entered)

REPORT DOCUMENTATION PAGE		READ INSTRUCTIONS BEFORE COMPLETING FORM
1. REPORT NUMBER	2. GOVT ACCESSION NO.	3. RECIPIENT'S CATALOG NUMBER
4. TITLE (and Subtitle) Administration of Cost Accounting Standards		5. TYPE OF REPORT & PERIOD COVERED FINAL
		6. PERFORMING ORG. REPORT NUMBER
7. AUTHOR(s) Richard P. White Robert M. Weinstein		8. CONTRACT OR GRANT NUMBER(s) MDA903-77-C-0370
9. PERFORMING ORGANIZATION NAME AND ADDRESS Logistics Management Institute 4701 Sangamore Road Washington, D.C. 20016		10. PROGRAM ELEMENT, PROJECT, TASK AREA & WORK UNIT NUMBERS Task RE804
11. CONTROLLING OFFICE NAME AND ADDRESS		12. REPORT DATE January 1979
		13. NUMBER OF PAGES 33
14. MONITORING AGENCY NAME & ADDRESS (if different from Controlling Office)		15. SECURITY CLASS. (of this report) Unclassified
		15a. DECLASSIFICATION/DOWNGRADING SCHEDULE
16. DISTRIBUTION STATEMENT (of this Report)  "A" - Approved for Public Release; Distribution Unlimited		
17. DISTRIBUTION STATEMENT (of the abstract entered in Block 20, if different from Report)		
18. SUPPLEMENTARY NOTES		
19. KEY WORDS (Continue on reverse side if necessary and identify by block number)  Cost Accounting Standards (CAS) Administration ACO		
20. ABSTRACT (Continue on reverse side if necessary and identify by block number)  This report examines the process for administering CAS requirements within DoD and concludes that extensive revision of procedures is not necessary. The report states that many administrative contracting officers (ACOs) have difficulty executing the CAS requirements; that, as a group, ACOs are inadequately prepared to make the necessary decisions; that CAS administration is done more intensively when the ACO is located at the contractor's plant; and that prime contractors rarely administer the CAS provisions in their subcontracts.		

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20. Abstract (continued)

The report concludes that DoD could make more effective use of people and time by improving the capabilities of ACOs and recommends actions to give those administering CAS the knowledge and skills needed to make required decisions. It recommends creation of a single office in DoD to be responsible for all DoD CAS interpretations and guidance, recommends other specific tasks and procedures for that office and recommends elimination of CAS specialists at all organizational levels between ACO and the CAS Office. It also recommends that DoD consider proposing changes to the CAS Board that would exempt negotiated defense contracts based on adequate price competition and that would restrict application of CAS to major contractors with on-site ACOs and subcontractors who also hold CAS-covered prime contracts.

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